Elizabeth Gil García*

Addressing Hybrid PE Mismatches: The Guidance of the Code of Conduct Group

This note addresses hybrid permanent establishment (PE) mismatches involving third countries. The author examines the *McDonald's* case, an example of a hybrid PE scenario, in the context of recent guidance approved by the Code of Conduct Group.

1. Introduction

The OECD, in Action 7 of the BEPS Action Plan,[1] targets permanent establishments (PE) due to the possibility of avoiding PE status. In June 2016, the Code of Conduct Group approved guidance and explanatory notes on hybrid PE mismatches involving third countries (the Guidance).[2]

While BEPS Action 7 proposes changes to the PE concept to prevent the avoidance of PE status, the Guidance is intended to correct mismatches with regard to hybrid PE issues. Thus, although the purpose of the Guidance is not to address the avoidance of the PE condition, hybrid PE mismatches are, in the end, a form of tax avoidance.

2. Hybrid PE Mismatches Involving Third Countries

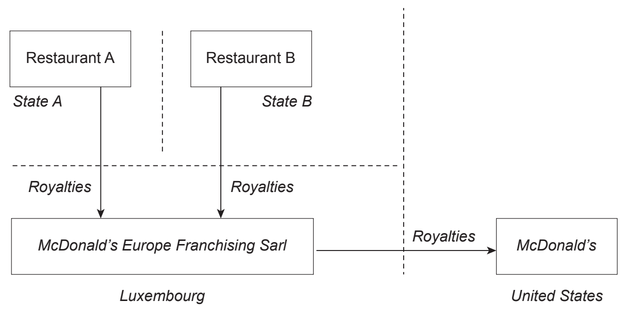
2.1. The *McDonald's* Case

The McDonald's group of companies, located in the United States, has a subsidiary in Luxembourg, "McDonald's Europe Franchising Sarl". This branch is a holding company that owns the intellectual property (IP) rights of the group in Europe. Indeed, the profits of the Luxembourg company are based on royalties paid by restaurants franchised in Europe and Russia for the use of the McDonald's brand and other related services as per Diagram 1.

In Diagram 1, "Restaurant A" and "Restaurant B" are restaurants located in "State A" and "State B", respectively, that pay royalties to the subsidiary "McDonald's Europe Franchising Sarl" located in Luxembourg. Royalties received by the Luxembourg company are allocated to its US branch.

On 30 March 2009, the tax authorities in Luxembourg gave a tax ruling to the effect that "McDonald's Europe Franchising Sarl" was not obliged to pay the corporate income Tax (CIT) in its territory due to it being subject to tax in the United States under the Luxembourg-United States Income and Capital Tax Treaty (1996) (the Treaty).[3] Article 13 of the Treaty establishes that royalties are taxable only in the state where the beneficial owner is resident. However,

Diagram 1: McDonald's case



> 3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein (…) In such case the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), as the case may be, shall apply.

Consequently, articles 5 (PE), 7 (Business Profits) and 25(2) (Relief from Double Taxation) of the Treaty should be taken into account in this case. In general terms, article 5 of the Treaty defines PE *status* in a similar way as article 5 of the OECD Model (2014).[4] Article 7 of the Treaty points out, however, that:

> 1. The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the business profits of the enterprise may be taxed in the other State but only so much of them as are attributable to that permanent establishment.

Finally, article 25 of the Treaty states that:

> In Luxembourg double taxation shall be eliminated as follows:
>
> a) where a resident of Luxembourg derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the United States, Luxembourg shall […] exempt such income or capital from tax […].

* **PhD Researcher at the Tax Law Department of the University of Alicante.** **The author would like to thank Prof. María Teresa Soler for her support while writing this article.** **The author can be contacted at: elizabeth@ua.es.**

1. OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (5 Oct. 2015), International Organizations' Documentation IBFD.
2. Guidance on Hybrid Permanent Establishment Mismatches concerning a Member State and a third state (doc. 9912/16), Brussels, 13 June 2016, available at: http://data.consilium.europa.eu/doc/document/ST-9912-2016-INIT/en/pdf (accessed 2 Jan. 2017).
3. *Convention between the Government of the United States of America and the Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital* (3 Apr. 1996), Treaties IBFD.
4. *OECD Model Tax Convention on Income and on Capital* (26 July 2014), Models IBFD.

Consequently, and according to their interpretation of the Treaty, the Luxembourg tax authorities confirmed that "McDonald's Europe Franchising Sarl" was not required to pay the CIT in Luxembourg because the profits were subject to taxation in the United States. Under the tax ruling of 30 March 2009, McDonald's was required to submit proof every year that the royalties transferred to the US branch were declared and subject to taxation in the United States. From a Luxembourg tax perspective, the subsidiary, "McDonald's Europe Franchising Sarl", was characterized as a PE, as it performed enough activities to consider that the US branch had a real presence in its territory. From a US point of view, however, such a subsidiary could not be characterized as constituting a taxable presence in the United States. Consequently, McDonald's was not able to prove that the profits had been subject to tax in the United States.

McDonald's clarified this in a submission requesting a second ruling, insisting that Luxembourg should nevertheless exempt the profits not taxed in the United States from taxation in Luxembourg. A few months later, on 17 September 2009, the Luxembourg tax authorities issued a second tax ruling according to which McDonald's was no longer required to prove that the income was subject to taxation in the United States. This ruling confirmed the tax exemption granted to "McDonald's Europe Franchising Sarl", although it was noted that the income resulting from the entity was also not taxed in the United States.

In December 2015, the European Commission opened a formal probe into Luxembourg's tax treatment of McDonald's, based on article 108(2) of the Treaty on the Functioning of the European Union (TFEU) (2007).[5, 6] It took the initial position that, by means of a tax ruling, the subsidiary enjoyed a favourable tax treatment that is contrary to the State aid rules and, consequently, incompatible with the internal market.[7]

In the author's view, two matters should be considered. The first is the investigation currently being carried out by the Commission relating to the incompatibility of the ruling with the State aid rules in article 107 of the TFEU. Such rulings are not *per se* an issue under State aid rules if they only confirm the application of the law. When such rulings grant a tax advantage to certain undertakings – in the form of aid –, however, they may severely distort competition within the internal market and contravene State aid rules. Thus, the decision of the Commission to classify this type of individual ruling under State aid rules is based on the objective of protecting free competition in the internal market. Nevertheless, it should be highlighted that tax rulings are intended to provide legal certainty with regard to transactions. Given the investigation, these transactions might now need to be altered.

The second matter relates to the situation of double non-taxation. This situation arises due to mismatches between Luxembourg's norms and US legislation on the recognition of the PE status of the branch, "McDonald's Europe Franchising Sarl". In the author's view, however, the existence of a PE should be based on an analysis of the articles of the Treaty. In this vein, according to Haslehner (2016), the Commission has not addressed article 5 of the Treaty; instead, it has taken into account the explanation given by McDonald's to support its argument that there is no PE for US tax purposes. Haslehner highlights that just because there is no PE for US tax purposes, that does not mean that the United States would not consider a PE to exist for treaty purposes.[8]

As previously noted, article 25(2) of the Treaty states that, in order to eliminate double taxation, Luxembourg must grant an exemption in respect of income that "may be taxed" in the United States. This condition should not be considered a requirement to be effectively taxed. According to the Commission:[9]

> […] the decisive element is whether the Source State (the United States) may tax the income in question under the tax treaty because of the existence of a PE subject to tax in the United States, not that the United States actually imposes taxes pursuant to its domestic tax law on that income.

The Commission has yet to issue a final decision on this case, but its preliminary view is that the tax rulings constitute State aid. The US Treasury Department is, however, carefully following the Commission's proceeding and will consider its implications for the United States.[10]

There is no doubt that the *McDonald's* Case is a clear example of a situation of double non-taxation. This is a scenario in which, due to domestic legislation, mismatches with regard to the recognition of a PE arise. The Treaty, in an attempt to avoid double taxation, not only eliminates it but also achieves the opposite result.

In June 2016, the Minister of Finance submitted a draft bill to Parliament that aims to prevent certain tax planning practices that may have arisen in the past with regard to companies formed under Luxembourg law that receive income from US sources.[11] In addition, the US Treasury

5. Treaty on the Functioning of the European Union of 13 December 2007, OJ C115 (2008), EU Law IBFD.
6. European Commission Press Release IP/15/6221, State aid: Commission opens formal investigation into Luxembourg's tax treatment of McDonald's (3 Dec. 2015), available at http://europa.eu/rapid/press-release_IP-15-6221_en.htm (accessed 5 Oct. 2016).
7. State Aid – Luxembourg, State aid SA.38945 (2015/C) (ex 2015/NN) – Alleged aid to McDonald's, Invitation to submit comments pursuant to Article 108(2) of the Treaty on the Functioning of the European Union (Text with EEA relevance) (2016/C 258/03), OJ C 258/11 (15 July 2016) (accessed 6 Oct. 2016). A ruling can only be considered a selective measure if it results in unequal treatment to the effect that certain undertakings or the production of certain goods are favoured over others (M. Lang, *Tax Rulings and State Aid Law*, British Tax Rev. 3, p. 394 (2015).
8. W. Haslehner, *The McDonald's State Aid Case – The EU Commission Interprets a Tax Treaty*, Kluwer International Tax Blog (22 June 2016), available at http://kluwertaxblog.com/2016/06/22/the-mcdonalds-state-aid-case-the-eu-commission-interprets-a-tax-treaty/ (accessed 13 Oct. 2016).
9. Commission, *supra* n. 7, at para. 88.
10. *The European Commission's Recent State Aid Investigations of Transfer Pricing Rulings: U.S. Department of the Treasury White Paper* (24 Aug. 2016), available at https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/White-Paper-State-Aid.pdf (accessed 13 Oct. 2016).
11. *OECD – Draft bill on assignation of specific taxation powers between Luxembourg and the United States submitted to Luxembourg parliament* (23 June 2016), News IBFD. All information related to the draft law on the assignation of specific taxation powers between Luxembourg and the Unites States submitted to the Luxembourg Parliament is available on the website

Department has released a statement in respect of the negotiation of a Protocol to amend a number of provisions of the Treaty.[12] In particular, the following clause will be added to an eventual Protocol:

> Where an enterprise of a Contracting State derives income from the other Contracting State, and the first-mentioned Contracting State treats that income as profits attributable to a permanent establishment situated outside of that Contracting State, the benefits of this Convention shall not apply to that income if:
>
> a) the income that is treated as profits attributable to the permanent establishment is subject to a combined aggregate effective rate of tax in the first-mentioned Contracting State and the state in which the permanent establishment is situated that is less than the lesser of (i) 15 percent or (ii) 60 percent of the general statutory rate of company tax applicable in the first-mentioned Contracting State; or […].

It appears that this provision is intended to avoid situations of double non-taxation. Applying this provision to the case analysed in this section, a company, located in the United States ("the first-mentioned contracting state"), obtains income from Luxembourg ("the other contracting state"), but a PE is not recognized. As such, it does not seem that this provision will solve the lack of taxation in the *McDonald's* case, as the income obtained in the first contracting state (residence state) is not treated as profits attributed to a PE. Thus, the situation of double non-taxation would remain.

2.2. The Guidance of the Code of Conduct Group

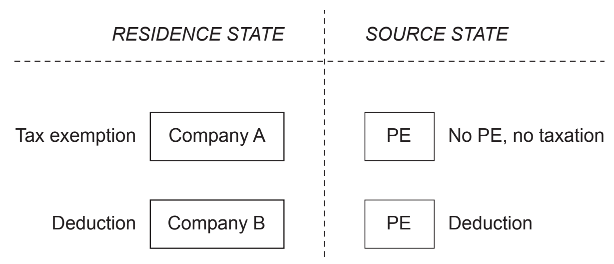
In July 2015, the Code of Conduct Group agreed to focus on third-country aspects of hybrid entities and hybrid PEs. A year later, the Group approved the Guidance and explanatory notes on hybrid PE mismatches involving third countries. The above-mentioned case, as well as gaps in the Treaty, led the Group to make proposals to ensure taxation of the income at issue.

The Guidance, first, sets out some definitions, such as the concept of a hybrid PE, which is the cornerstone of the Guidance. It should be highlighted that, as the explanatory notes state, the meaning given to terms set out in the Guidance is only intended to apply for the purposes of the Guidance and is not intended to have any wider significance.

The pre-condition for the existence of a hybrid PE is that an enterprise resident in one state (residence state) carries on business activities in another state (source state). There are two types of hybrid PEs. First, a PE is treated as hybrid where the business activities of an enterprise are not recognized as being carried on through a PE in the state where those activities are carried on (source state) but are recognized as carried on via a PE in the state where the company is resident (residence state). The second type of hybrid PE refers to a situation in which the business activities are recognized as being carried on through a PE only in the state where those activities are carried on (source state).

Thus, these two scenarios refer to an inconsistent treatment of business activities that might lead to situations of double non-taxation. The first scenario involves a specific type of double non-taxation, i.e. non-taxation without inclusion resulting from an inconsistent treatment by two states (as in the *McDonald's* case). The second type of double non-taxation refers to a double deduction resulting from an inconsistent treatment of business activities by the residence state and the source state.

Diagram 2: Double non-taxation and double deduction



In Diagram 2, two scenarios are shown: a double non-taxation scheme and a double deduction situation. In the first scenario, the residence state grants a tax exemption to "Company A" based on the attribution of profits to the PE and the source state does not levy tax on the income obtained by the non-resident entity (Company A) because such income is not considered as generated through a PE. Thus, the mismatch is relevant for tax purposes, as it implies the double non-taxation of such income. Consequently, and according to the explanatory notes, non-taxation without inclusion can only arise where the residence state of the enterprise eliminates double taxation of profits from business activities carried on in the source state by way of the exemption method.[13]

In the second scenario, the residence state and the source state allow a deduction (or other tax relief) to "Company B" and to the PE, respectively, with regard to the same payment, expense or loss attributed to a hybrid PE, insofar as that payment, expense or loss is deducted from or relieved against income that is not attributed to the hybrid PE. In this scenario, the explanatory notes point out that a double deduction can arise when the residence state eliminates double taxation through either the credit or exemption method. This is because the residence state does not recognize the existence of a PE.

of the Ministry of Finance of Luxembourg at http://www.mf.public.lu/actualites/2016/06/fisc_usa_220616/index.html (accessed 13 Oct. 2016).

12. *Bilateral Tax Treaty Negotiations between the United States and Luxembourg*, available at https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Luxembourg-Statement-06222016.pdf (accessed 13 Oct. 2016).

13. Employment of the credit method should not exclude any profits from business activities from tax in the residence state and, therefore, this type of effect should not arise.

According to the explanatory notes, if an aggressive tax planning arrangement were to involve more than one mismatch situation, the guidance would apply to each mismatch situation separately.

Hence, once the meaning of certain terms has been determined, the Guidance provides for the treatment of the hybrid PE to be aligned, i.e. where a mismatch in treatment would otherwise result in non-taxation without inclusion or double deduction. It should be noted that the application of the Guidance is restricted to situations involving a Member State and a third state, thus excluding situations in which the residence state and source state are EU Member States.

Concerning the first scenario, when the result of a mismatch situation leads to non-taxation without inclusion, the Member State concerned, in order to prevent this situation, should treat the business activities as if they were not being carried on through a PE, assuming the third State does not recognize the existence of the PE. Where, however, the third state treats the business activities as if they were being carried on via a PE, the Member State should treat those activities as if they were being carried on through a PE. Therefore, the Member State should follow the treatment given to business activities by the third state.

For instance, looking at Diagram 2, assume that "Company A" is resident in a third State (residence state), which recognizes a PE located in a Member State (source state). According to the Guidance, and for the sole purpose of preventing double non-taxation, the Member State should treat the business activities as if they were being carried on through a PE. As a result, income derived from the PE would be subject to tax in the source state, while the tax exemption given by the residence state would still be applicable to "Company A" due to it being considered attributable to a PE.

In the *McDonald's* case, the United States (the third state) does not recognize the existence of a PE, while Luxembourg (the Member State) treats the subsidiary, "McDonald's Europe Franchising Sarl", as a PE and grants an exemption. In line with the Guidance, as the third state does not recognize the existence of a PE, the Member State concerned should treat the business activities as if they were not being carried on through a PE. As such, the resulting alignment of treatment of the hybrid PE would resolve the double non-taxation, i.e. not considering the subsidiary as a PE from the perspective of Luxembourg would lead to the application of the domestic legislation (i.e. the Corporate Income Tax Act) in order to tax the income generated by the entity located in the territory of that Member State.

In order to prevent a double deduction scenario, however, where the third state treats the business activities as if they were not being carried on through a PE, the Member State should also treat the business activities as if they were not being carried on via a PE. In addition, where the third state treats the business activities as if they were being carried on via a PE, the Member State should consider that a PE exists. Looking again at Diagram 2, assume, for instance, that Company B is resident in a Member State (residence state) that does not recognize the entity located in the third state (source state) as a PE. As the source state treats the business activity as being carried on through a PE, the Member State should consider that a PE exists.

It is possible, however, that the double deduction will not disappear even if the Guidance is followed. For this reason, the Code of Conduct Group states that, in such a scenario, the Member State should remove the double deduction by denying the company carrying on the business activities deductions that give rise to a mismatch. Based on the example, the Member State should deny the deduction in the hands of Company B.

As stated by the Code of Conduct Group, the determination of whether or not a business activity should be treated as being carried on through a PE should be made in accordance with the Guidance. A determination contrary to the treatment that would otherwise apply should only be made to the extent necessary to achieve the objective of avoiding a double deduction or non-taxation without inclusion situation. Consequently, the Guidance will be applied only when other means are not sufficient to prevent this kind of situation. Further, the Guidance should not be applied in situations of asymmetrical treatment of income and double taxation, as it is only intended to prevent hybrid PE mismatches resulting in non-taxation without inclusion or double deductions.

As noted, the proposals contained in the Guidance are intended to correct hybrid PE mismatches when the residence and the source state are not Member States. Nevertheless, the explanatory note points out that, in the event of an intra-EU hybrid PE mismatch, Member States should agree as to whether or not the business activities should be treated as being carried on through a PE. Moreover, the Guidance should not interfere with the provisions of tax treaties; if the Guidance results in taxation that is not in line with a tax treaty, Member States should endeavour to resolve the issue by mutual agreement.

3. Concluding Remarks

The Guidance of the Code of Conduct Group does not target tax avoidance through the use of a PE as BEPS Action 7 does. The Guidance tackles hybrid PE mismatches resulting in non-taxation without inclusion or double deductions. Having said this, it should be highlighted that hybrid PE mismatches are, at the end of the day, a form of tax avoidance.

The Guidance, as outlined herein, is organized into three parts. First, it defines certain terms, such as "hybrid PE" or "mismatch situation", among others. Second, it ensures that the treatment of the hybrid PE is aligned between the source state and the residence state to prevent non-taxation without inclusion or double deduction. Finally, it ensures that this alignment is not used to achieve unintended results.

In the *McDonald's* case, the investigation carried out by the Commission is ongoing, but the Commission will likely conclude that the ruling constitutes State aid that is incompatible with EU Law. Nevertheless, in the author's view, this case requires a careful analysis of the Treaty. In particular, consideration should be given to whether or not there is a PE located in Luxembourg in light of the Treaty, allowing then for the taxation of such income as obtained through a non-resident entity.